12.2 INTERNATIONAL TAXATION

International Taxation may be referred to as the international aspects of the income tax law of a particular countries with minor exceptions tax laws. International taxation in a simple language means the study of Taxation beyond the National Level. Though we all are very much aware about our Indian Taxation Laws but as time is demanding something more so, there is a need to study the taxation at another level.

International Tax is best regarded as the body of legal provisions of different countries that covers the tax aspects of cross - border transactions. It is concerned with Direct Taxes and Indirect Taxes

Important categories of International tax are as under :

- The income tax aspects of cross - border trade in goods and services
- Cross border manufacturing by a Multinational companies.
- A cross border investment by individuals or by Investments Funds
- The taxation of Individuals who work or do business outside the countries where the usually reside.

The International tax laws of countries has two broad dimensions :

- The taxation of resident individuals and corporations on Income arising in foreign countries
- The taxation of Non-Resident on Income arising domestically

A transaction involving the export of capital or other resources from the countries is often referred to by tax analysts as an outward bound or outbound transaction. The term inbound transaction is used to refer to a transaction involving the import of capital or other resources from a foreign countries.

Tax Havens

A Tax havens is a state country or territory where certain taxes are levied at a low rate or are not taxable at all. Individuals and/or corporate entities can find it attractive to establish shell subsidiaries or move themselves to areas where reduced or nil tax is charged. These creates a situations of tax competitions among government. Different Jurisdictions tend to be havens for different type of taxes and for different categories of people or companies.

Many countries modifies tax laws to attract foreign capital could be considered a tax haven. First true tax haven was Switzerland followed closely by Liechtenstein. Swiss bank had long been a capital haven for people fleeing social upheaval in Russia, Germany, South America and elsewhere.

The following Characteristics are indicative of a tax haven :

- Nil or Nominal Tax are applicable
- Lack of effective exchanges of tax information with foreign tax authorities
- Lack of transparency in the operation of legislative, legal, or administrative provision
- No Requirement for a substantive local presence
- Self-promotion as an offshore financial center.

Way of Tax Haven

Not only individuals, but every company wants to maximize its profit and minimize the tax that has to be paid. Tax minimization is the fundamental motive for companies to generate profits in tax havens. Therefore, many multinational companies based in high tax countries try to have their tax planning strategies to decrease the tax payable and thus increase their profits after tax.

Tax havens are frequently used by multinational companies to shift profits. Also, there are a variety of choices which can be adopted through the use of tax havens.

Controlled Foreign Corporation (CFC)

The history of controlled foreign corporations in United States tax law is characterized by reduction of the tax deferral advantages of United States corporations operating businesses overseas through foreign corporations. Four major pieces of legislation have defined and extended the concept of a controlled foreign corporation and the mechanism by which foreign corporation earnings are includable in the U.S. shareholder's taxable income

CFC rules were first introduced in the US in 1964 and are now widely adopted in many EU countries in order to combat tax avoidance. In recent years, there has been an active policy debate around the CFC rules.

CFC rules are the useful legislative measure for many countries that are likely to encounter tax avoidance. It is the most direct and extensive way of combating the profit shift of passive income to low-tax jurisdictions. Other measures are sometimes considered as subordinate to CFC rules. This becomes more and more important in the recent international tax policy debate.

For an Example if a parent country is established in a high-tax home country and it owns a subsidiary in a low-tax host country, the parent company would definitely favor taxing its income in the host country. In addition, it is important to note how the home country treats the foreign come of its residents. Exemption method, credit method and tax sparing credit are the three common methods that are adopted worldwide

CFC status was set up under in 1962, these rules incorporate most of the features of CFC rules used in other countries.

GAAR (General Anti-Avoidance Rules)

GAAR is the important concept which generally empowers the revenue authorities in a country to deny the tax benefit of transaction or arrangement which do not have any commercial substance or consideration other than achieving the tax benefit.

GAAR is set of rules under the Income Tax Act (under the proposed Direct Tax Code) which empowers the revenue authorities to deny tax benefits transactions or arrangements which do not have any commercial substance or consideration other than achieving the tax benefit. Thus, in nutshell, we can say that GAAR usually consists of a set of broad rules which are based on general principles to check the potential avoidance of the tax in general.

Australia introduced such rules way back in 1981. Later on countries like Germany, France, Canada New Zealand, South Africa etc. However, countries like USA and UK have adopted a cautious approach and have not been aggressive in this regard.

In India the real discussion on GAAR came to light the resale of Direct Taxes code Bill (DTC 2009) which revised in June 2010. According to the press release by CBDT (Central Board of Direct Taxes), GAAR provisions shall be effective from assessment year 2018-19 onwards. The provisions of GAAR are contained in Chapter X-A of the Income Tax Act, 1961. The procedures for application of GAAR and conditions under which it shall not apply, are enumerated in Income-tax Rules, 1962.

Difference between GAAR and SAAR

Anti-avoidance Rules are broadly divided into two categories

- General Anti Avoidance Rule (GAAR)
- Specific Anti Avoidance Rule (SAAR)

In the case of the former, the legislation will be GAAR whereas in the case of the latter, the legislation is in the form of Specific Avoidance (SAAR). Special rules are targeted at individual, case by case specific provisions. Legislations with respect to general rules are known as GAAR and legislations with respect to special rules are known as SAAR.

12.2.1 Double Taxation Relief

Double Taxation means taxation of same income of person in more than one country. This result due to countries following different rules for income taxation. DTAs has been the avoidance of double taxation. The solution to that problem necessarily involves taxing income only once and that leads to consideration of which country will have the taxing right. More recently, DTAs have also developed into instruments to prevent tax evasion in a cross-border context.

OECD Model : Organization of Economic Co-operation and Development (OECD) Model Double Taxation Convention on Income and on Capital, issued in 1977, 1992 and 1995

OECD Model is essentially a model treaty between two developed nations. This model advocates residence principle, that is to say, it lays emphasis on the right of state of residence to tax.

There are two main rules of Income taxation :

(a) **Sources of Income Rules :** The Income may be subject to tax in the country where the source of such Income exists (Where business situated and property is located) whether the Income earner is a resident in that country or Not

(b) **Residence Rules :** Stipulated that the power to tax should rest with the country in which tax-payee resides.

The Government of the two countries can enter into Double Taxation Avoidance (DTAA's) so that the same income may not be taxed twice. DTTA's is the rules of taxation of Income by sources of country and the residence of the country. These rules are various categories of income such as interest, dividends royalties capital gain etc.

DTAA's provides relief against such Double taxation. these relief such hardship can be provided mainly in two ways.

(i) Bilateral Relief

(ii) Unilateral Relief

(i) **Bilateral Relief :** Under this method the Government of two countries can enter into an agreement to provide relief against Double taxation by mutually working out the basis on which relief is to be granted. This is called bilateral relief.

Bilateral Relief may be granted either one of the following method.

(a) **Exemption Method :** Which of a particular Income is taxed in only one of the two countries.

(b) **Tax Relief Method :** If any item of Income is taxed in both the countries the assesse should get relief in a particular manner. Under this method the assesse is liable to have his Income taxed in both countries but is given a deduction from the tax payable by him in the country of the residence. This is known as tax credit method of relief.

(ii) **Unilateral Relief :** When there is no mutual agreement between the countries, relief is provided by the home country.

In simple words :

(i) In case there is DTAA with the Country, then Tax Relief can be claimed u/s 90.

(ii) In case there is DTAA with the Specified Associations, then Tax Relief can be claimed u/s 90A.

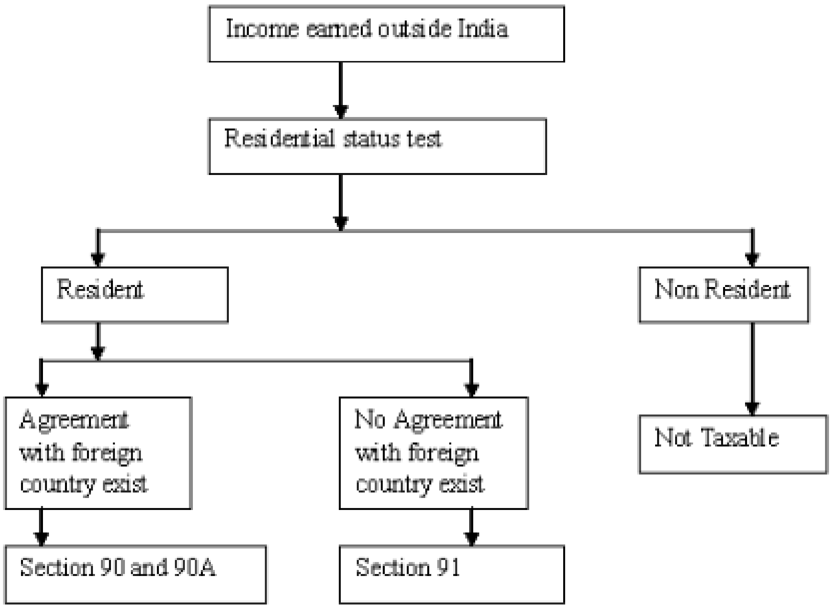
(iii) In case there is No DTAA, then Tax Relief can be claimed u/s 91.

Double Taxation Relief Provision in India

India has comprehensive Double Taxation Avoidance Agreements with 79 countries. There are agreed rates of tax and jurisdiction on specified types of income arising in a country to a tax resident of another country. Under the Income Tax Act, 1961 of India, there are two provisions, Section 90 and Section 91, which provide specific relief to taxpayers to save them from double taxation.

Section 90 is for taxpayers who have paid the tax to a country with which India has signed DTAA, while Section 91 provides relief to tax payers who have paid tax to a country with which India has not signed a DTAA. Thus, India gives relief to both kinds of taxpayers.

The application of section 90 and 91 can be explained with the help of the following diagram.



As can be seen from the above diagram that section 90 is applicable in cases where India has entered into a Bilateral agreement with other country and section 91 is applicable in case where there is no such bilateral agreement (i.e. there is unilateral agreement)

Agreement with Foreign Countries (Bilateral Relief) (Sec. 90)

Section 90 empowers the central Government to enter into an agreement with the government of any countries outside India or specified territory outside India to provide for the following:

- Income on which tax has been paid both under Income Tax Act, 1961 and Income Tax prevailing in that country or definite territory.
- Income tax chargeable under Income Tax Act, 1961 and according to the corresponding law in force in that country or specified territory to boost mutual economic relations, trade and investment.
- For the prevention of double taxation of income under Income Tax Act, 1961 and under the equivalent law in force in that country or specified territory.
- For exchange of information regarding the avoidance of evasion or avoidance of income tax chargeable as per Income Tax Act, 1962 or under the equivalent law in force in that country or specified territory, or investigation of cases of evasion or avoidance.
- For recovery of income tax under Income Tax Act, 1961 and under the equivalent law in force in that country of the specified territory.

Adoption by Central Government of Agreement between Specified Association for Double Taxation Relief (Sec. 90-A)

Any Specified association in India may enter into an agreement with any specified association in the specified territory outside India and the central Government may be notified in the official gazette make such provision as may be necessary for adopting and Implementing such agreement.

(a) For the granting of relief in respect of

  (i) Income on which have been paid both income-tax under this Act and income-tax in any specified territory outside India; or

  (ii) Income-tax chargeable under this Act and under the corresponding law in force in that specified territory outside India to promote mutual economic relations, trade and investment.

(b) For the avoidance of double taxation of income under this Act and under the corresponding law in force in that specified territory outside India, or

(c) For exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that specified territory outside India, or investigation of cases of such evasion or avoidance, or

(d) For recovery of income-tax under this Act and under the corresponding law in force in that - specified territory outside India.

- Where the Central Government has entered in to an agreement with the specified association of any specified territory outside India for the granting relief of tax, avoidance of double taxation, then, the provisions of Income Tax Act, 1961 shall apply to the assesse to whom such agreement applies, to the extent they are more beneficial to him.
- **"Specified Association"** for this section means any institution, association or body whether incorporated or not, functioning under any law for the time being in force India or the laws of specified territory outside India and which may be notified as such by the Central Government.
- **"Specified Territory"** means any area outside India which may be notified as such by the Central Government for the purpose of section 90A. The provision under this section will apply to the assesses to the extent these are beneficial to them. This section provides relief in respect of double taxation in respect of countries with which India has no DTAA.

Countries with which no Agreement Exists (Sec. 91) (Unilateral Relief)

If any person who is resident in India in any previous year proves that, in respect of his income which accrued or arose during that previous year outside India (and which is not deemed to accrue or arise in India). Assesse has paid in any country with which there is no agreement under section 90 for the relief or avoidance of double taxation, income-tax, by deduction or otherwise, under the law in force in that country.

In other word where section 90 does not apply unilateral Relief will be available with following conditions satisfied

(a) The assesse should be the resident in India in the previous year;

(b) The income should have accrued in fact outside India and should not be deemed under any provision of this Act to accrue in India;

(c) The income should be taxed both in India and in a foreign country with which India has no agreement for relief against or avoidance of double taxation.

(d) The assesse should have in fact paid the tax in such foreign country by deduction or otherwise.

(e) There should be no reciprocal arrangement for relief or avoidance from double taxation with the country where Income has accrued and arise

(f) In respect of that Income the assesse must have paid by deduction or otherwise tax under the law

- To a deduction from the Indian Income Tax payable by him or a sum calculated on such doubly taxed income so included
- At the Average Indian Tax Rate or
- The Average Foreign Tax Rate,

Whichever is lower or at the Indian Tax Rate if both the rates are equal.

Indian Tax on Doubly Taxed Income :

$$\frac{\text{Tax on Total Income in India} \times \text{Doubly Taxed Income}}{\text{Total Income in India}}$$

Foreign Tax on Doubly Taxed Income :

$$\frac{\text{Tax Paid in Foreign Country} \times \text{Doubly Taxed Income}}{\text{Total Income in Foreign Country}}$$

Steps for Calculating Relief under This Section

- First include the income earned and taxed in the foreign country along with the income earned in India.
- Then calculate tax on the Total income above.
- Now calculate average rate of tax.
- Then multiply such rate with the income earned from foreign country.
- Deduct tax paid in the foreign country from the tax calculated in step. 4 above, Such amount is relief u/ s 90.

Necessity for Double Taxation Avoidance Agreement (DTAA)

1. The need for Double Taxation Avoidance Agreement (DTAA) arises because of rules in two different countries regarding chargeability of income based on receipt and accrual, residential status etc.
2. Double taxation is frequently avoided through DTAAs entered into by two countries for the avoidance of double taxation on the same income.
3. The DTAA eliminates or mitigates the incidence of double taxation by sharing revenues arising out of international transactions by the two contracting states of the agreement.
4. As there is no clear definition of income and taxability thereof, which is accepted internationally, an income may become liable to tax in two countries.
5. In such a case, the possibilities are as under:
   - The income is taxed only in one country.
   - The income is exempt in both countries.
   - The income in taxed in both countries, but credit for tax paid in one country is given against tax payable in other country.

12.2.2 Transfer Pricing

In a cross border transaction, countries on either side would like to ensure that it gets its due share of taxes. Transfer Pricing Regulations seek to achieve this objective. Transfer pricing means pricing of goods, services or intangibles when they are provided for use or consumption to a related party (e.g. subsidiary, associate). Since it's possible for these related parties to transfer profits or losses between tax jurisdictions they operate under, such intra group transactions could be guise for potential tax avoidance.

The Finance Act 2012 has expanded the scope of chapter X of the Income Tax act by including Certain Specified domestic transaction under the transfer price regulations.

With a view to provide a detailed statutory framework which, can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, the Finance Act, 2001 substituted the then existing section 92 with sections 92A to 92F in the Income-tax Act, 1961, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of information and documents by persons entering into international transactions and definitions of certain expressions occurring in the said section. The Central Board of Direct Taxes (CBDT) has come out with Transfer Pricing Rules - Rule 10A to Rule 10E.

Provision of Transfer Pricing in Income Tax Act

- Computation of Income From transaction with Non-Resident (Sec. 92)
- Meaning of associated enterprises (Sec. 92A)
- Meaning of International Transaction (Sec. 92B)
- Computation of arm's length prices (Sec. 92C)
- Reference to transfer Pricing officer (Sec. 92 CA)
- Power to board to Make safe harbor rules (Sec. 92CB)
- Advance Pricing Agreement (Sec. 92 CC)
- Effect to advance Pricing agreement (Sec. 92 CD)
- Maintain and Keeping of Information and document by person entering to international transaction (Sec. 92 D)
- Report from an accountant to be furnished by person entering in to international transaction (Sec. 92 E)
- Definitions of certain terms relevant to computations of arm's length price (Sec. 92 F)

1. Computation of Income From Transaction with Non-Resident (Sec. 92)

Sec. 92 Provide that any Income arising from the International transaction shall be commutated having regard to "the arm length price". International Transaction means a transaction between Two or More associated enterprises either both of whom are Non Resident and such transaction is in the nature of Purchase and sales of Property or Provisions of services or leading and borrowing money.

Arm's Length Price included

(a) Not only the Income but expenses or Interests also to be determined at arm's length price (Sec. 92 (1)

(b) Sharing / Contributing of cost or expenses of any benefit etc. shall also be at arm's length price (Sec. 92 (2)

(c) Provisions of arm's length price not to apply if these result into reduction of Income or Increase of Loss (Sec. 92 (3)

The Provision of transfer pricing shall not apply in case where :

(i) The computation of Income

(ii) The determination of the allowance for any expenses or Interests

(iii) The determination of any cost or expenses allocated or apportioned or as the case may be computed as per sec. 92 (2)

2. Meaning of Associated Enterprises (Sec. 92 A)

Associated Enterprises means an enterprises is an associated enterprises only when it is viewed in relation to other enterprises. The relationship of associated enterprises (AEs) is defined by Section 92A of the Act to cover direct/ indirect participation in the management, control or capital of an enterprise by another enterprise. It also covers situations in which the same person (directly or indirectly) participates in the management, control or capital of both the enterprises.

Deemed Associated Enterprises

(a) Direct/indirect holding of 26% or more voting power in an enterprise by the other enterprise or in both the enterprises by the same person.

(b) Advancement of a loan, by an enterprise, that constitutes 51% or more of the total book value of the assets of the borrowing enterprise.

(c) Guarantee by an enterprise for 10% or more of total borrowings of the other enterprise.

(d) Appointment by an enterprise of more than 50% of the board of directors or one or more executive directors of the other enterprise or the appointment of specified directorships of both enterprises by the same person.

(e) Complete dependence of an enterprise (in carrying on its business) on the intellectual property licensed to it by the other enterprise.

(f) Substantial purchase of raw material/sale of manufactured goods by an enterprise from/ to the other enterprise at prices and conditions influenced by the latter.

(g) The existence of any prescribed relationship of mutual interest.

3. Meaning of International Transaction (Sec. 92B)

International Transaction means a transaction between two or more associated enterprises either or both of whom are Non-Residents. The transaction must be in Nature of Purchase, sales or Lease of tangible or Intangible property Provision of Services Lending or borrowing money

Any other transaction having a bearing on the profits, Income, losses or assets of such enterprises

A transaction of business restricting or reorganization

Further it shall include a mutual agreement or arrangement between two or more associated enterprises

The allocation or apportionment

Any contribution

the Finance Act 2012 has extended the application of transfer pricing regulations to 'specified domestic transactions', being the following transactions with certain related domestic parties, if the aggregate value of such transactions exceeds INR 5 crore:

- Any expenditure with respect to which deduction is claimed while computing profits and gains of business or profession.
- Any transaction related to businesses eligible for profit-linked tax incentives, for example, infrastructure facilities (Section 80-IA) and SEZ units (section 10AA).
- Any other transactions as may be specified.

4. Computation of Arm's Length Prices (Sec. 92C)

As per the provisions of section 92C the arms length price (ALP) in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe:

(a) Comparable Uncontrolled Price Method ("CUP")

(b) Resale Price Method ("RPM")

(c) Cost Plus Method ("CPM")

(d) Profit Split Method ("PSM")

(e) Transactional Net Margin Method ("TNMM")

(f) Any other method prescribed by CBDT

In this regard, the Central Board of Direct Taxes has notified that the 'other method' for determination of the arm's-length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts

5. Reference to Transfer Pricing Officer (Sec. 92 CA)

Where any person being the assesse has entered into an international transaction in any previous year and the assessing officer considers it necessary or expedient so to he may with the previous approval of the principal commissioner or commissioner refer the computation of the arm's length price in relation to the said international transaction under section 92C to the transfer Pricing officer.

6. Power to Board to Make Safe Harbor Rules (Sec. 92CB)

Safe harbor rule means circumstance in which the Income tax authorities shall accept the transfer price declared by the assesse.

Power of Board to make Safe Harbor Rules 92CB.

(1) The determination of arm's length price under section 92C or section 92CA shall be subject to safe harbor rules.

(2) The Board may, for the purposes of sub-section (1), make rules for safe harbor.

7. Advance Pricing Agreement (Sec. 92 CC)

An APA is an agreement between the Central Board of Direct Taxes and any person, which determines, in advance, the arm's length price or specifies the manner of the determination of arm's length price (or both), in relation to an international transaction. Hence, once APA has been entered in to with respect to an international transaction, the arm's length price with respect to that international transaction, for the period specified in the APA, will be determined only in accordance with the APA.

The APA process is voluntary and will supplement appeal and other Double Taxation Avoidance Agreement (DTAA) mechanism for resolving transfer pricing dispute. The term of APA can be a maximum of five years.

The APA scheme makes available 3 types of APA:

Unilateral, Bilateral and Multilateral

The choice is on the applicant to choose a particular type of APA at the time of making the application.

Unilateral APA is an agreement between the Board and the applicant and this process does not involve any agreement with the treaty partner.

In bilateral and multilateral APA request, the applicant is required to make an application with the Competent Authority of India as well as the Competent Authority of the other country.

8. Effect to Advance Pricing Agreement (Sec. 92 CD)

The Indian authorities have introduced unilateral, bilateral and multilateral APAs with effect from 1 July 2012. There are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible for applying for an APA. However, the APA mechanism is not available for specified domestic transactions

9. Maintain and Keeping of Information and Document by Person Entering to International Transaction (Sec. 92 D)

Every person who has entered into an international transaction or specified domestic transaction shall keep and maintain such information and document in respect thereof, as may be prescribed.

The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceeding under this Act, require any person who has entered into an international transaction or specified domestic transaction to furnish any information or document in respect thereof, as may be prescribed under sub-section (1), within a period of thirty days from the date of receipt of a notice issued in this regard :

Provided that the Assessing Officer or the Commissioner (Appeals) may, on an application made by such person, extend the period of thirty days by a further period not exceeding thirty days.

10. Report from an Accountant to be Furnished by Person Entering in to International Transaction (Sec. 92 E)

Every person who has entered into an international transaction or specified domestic transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed

11. Definitions of Certain Terms Relevant to Computations of Arm's Length Price (Sec. 92 F)

The term "arm's length price" is defined in section 92F(ii) to mean :

- The price which is applied, or
- Is proposed to be applied
- In a transaction between persons other than AEs
- In uncontrolled conditions.

The term "enterprise" is defined in section 92F(iii) to mean a "person" including a "permanent establishment" of a person who is, or has been or is proposed to be "engaged in" certain specified activities. These activities are in relation to :

- Production storage, supply, distribution, acquisition or control of:
- Articles or goods; or
- Know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature; or
- Any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process:
- Of which the other enterprise is the owner; or
- In respect of which the other enterprise has exclusive rights;

OR

- Provision of services of any kind;

OR

- Carrying out any work in pursuance of a contract;

OR

- Investment

OR

- Providing loan

OR

- Business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate.

Such activity or business may be carried on directly or through one or more of the units or divisions or subsidiaries, which may be located at the same place where the enterprise is located or at a different place(s).

The term **"Permanent Establishment"** is defined to include a fixed place of business through which the business of the enterprise is wholly or partly carried on.

An **"enterprise"** is an AE :-

Which participates directly or indirectly in the management or control or capital of the other enterprise.